

Working Paper #2

The White Paper on the DAK: Arguments and Possible Solutions

Unlike in the past when the DAK (*Dana Alokasi Khusus*) was an important element of fiscal decentralization policy in Indonesia, the transfer scheme of DAK is currently becoming less relevance due to conceptual as well as practical issues. The DAK is designed a conditional matching grant to sub-national governments to finance physical investments in selected infrastructure projects. While the government is preparing a draft for revising Law No.33/2004 on Fiscal Balancing, there is still a question as to whether the regulatory framework for DAK, Government Regulation No.55/2005, would also be changed.

According to Government Regulation No.55/2005 on DAK (especially article 1), the objectives of DAK transfer are as follows:

- It aims to support special activities (*kegiatan khusus*)
- It is targeted to selected sub-national governments (*di daerah tertentu*)
- It is related to sub-national government responsibility (*yang merupakan urusan daerah*)
- It is in line with national priorities (*sesuai dengan prioritas nasional*).

Further explanations (*penjelasan*) of the Government Regulation, however, show that the DAK scheme has inherent conflicting objectives as it is also aimed at:

- providing physical infrastructures for basic public services (*sarana dan prasarana fisik pelayanan dasar masyarakat*)
- incur a long economic lifetime (*proyek dengan umur ekonomis yang panjang*).

As the Bappenas is one of the strategic national agencies responsible for ensuring that DAK scheme comply with national priorities as stated in the RPJMN document and for monitoring and evaluating the outcomes of DAK-financed activities, it is critical for the Bappenas to have a sound conceptual framework as well as practical guidelines on the DAK. The white paper on DAK should cover integrated information on the current status and the future of policies related to the financial transfer. It must have a sound theoretical basis, solid factual arguments, and a clear guideline on for the future of DAK policy. The white paper can in fact give notice for solutions, including those that might require some revisions in Government Regulation No.55/2005 and Law No.33/2004.

Key Issues in Current DAK

Issue of **multiple-objectives**. Unlike the other transfer schemes with certain objective, such as the DBH, DAU, Dana Otsus and Dana Penyesuaian, the DAK is burdened by various objectives. The primary objective of DAK is to help sub-national governments finance special activities in accordance with national priorities, in order to reduce sectoral inequalities among the kabupaten and kota.

At the same time the DAK attempts to reduce fiscal inequalities among *kabupaten* and *kota* by taking the fiscal capacity of a sub-national government into account when calculating the allocation. There is also a third objective of providing additional finance sources to special status provinces, i.e. Papua, Irijaab and Aceh. The objectives of DAK allotment are also overlapped with other transfer schemes. For instance, DAK objective as an instrument for providing additional finance to provinces is overlapped with that of the Dana Otsus, and the objective of reducing fiscal inequalities among sub-national governments is overlapped with that of the DAU. As a result of the issue of multi-objectives, the DAK allotment is increasingly losing its focus. Both the number of districts and the number of sectors that are financed by DAK have increased over time.

Issue of **inequitable allocations**. The impacts of DAK allotment is increasingly against the initial design of DAK. In the current status of Local Fiscal Capacity Map (*Peta Kapasitas Fiskal Daerah*) reported in the PMK 174/2009, it appears that DAK allotments are against the objective of creating equitable development at the sub-national levels. DAK tends to favor district governments with "high" or "very high" fiscal capacity instead of district governments with "medium" and "low" fiscal capacity. Therefore, DAK allocation method needs to be revamped if further deterioration is to be avoided.

Issue of **unpredictability**. For most of decision makers at the sub-national governments, the amount and the time of distribution of DAK funds is highly unpredictable. Even for the central government authorities, the proportion of DAK among the other inter-governmental fiscal transfers does not have a clear pattern. The total DAK allotment for 2010, for instance, was decreased by 13% compared to that of 2009. One would assume that in 2010 the districts would receive about 13% lower than the previous fiscal year. However, the reality is that most of the districts in 2010 either received much higher or much lower than that of in 2009. The total proportion of the DAK in the inter-governmental transfers cannot be used as a benchmark for decision makers at the district level. As a result, many districts would not be able to make DAK allotment to finance medium-term projects.

Issue of **disregarding performance**. Despite the fact that the Ministry of Finance has made the methodology for calculating DAK allocations is opened to public, the parameters (with more than 70 variables related to each districts) are not released. For most of local government authorities, the allocation method of DAK is not transparent. Many complain that the parameters for calculating DAK allocations are not based on objective performance of the district governments. As the central government allocates a great deal of DAK funds to finance local government office buildings in newly created districts (under the scheme of *DAK Prasarana Pemerintah*), the DAK allocation is strongly in favour of *pemekaran* (creation of new districts). DAK allocations are currently allocated more to the newly created region at the expense of those in other districts. Therefore, it can also be concluded that DAK is contributing to the *pemekaran*. Amid strong criticisms from various corner that *pemekaran* policy has resulted in high budgetary costs and limit benefits, there has been no breakthrough with regards to the DAK allocations.

Issue of **political intervention**. There has been a growing perception among the district authorities that DAK allocations are not strictly based on the official formula, but also influenced by lobbies with the members of parliament (DPR). In recent years, officials of the MoF have found that many DPR members frequently asked the ministry to add some parameters in the DAK formula that in fact resulted in revisions to the allocations of DAK funds to some districts. The DPR members stopped asking for revisions only after the introduction of other transfer scheme called *Dana Penyesuaian* (adjustment funds), which has substantially increased from Rp 0.5 trillion in 2006 to Rp 21.2 trillion in 2010. The extent of political intervention is shown in 2010 when the DPR even changed the additional DAK into the so-called *Dana Penguatan Desentralisasi Fiskal dan Percepatan Pembangunan Daerah* (Fiscal Decentralization and Local Development Acceleration Fund) of Rp 7.1 trillion without any reference to the DAK formula.

In order to address the above explained issues, the Bappenas white paper on DAK should come up with integrated solutions, which cover all aspects of problematic policy on the ground. International experience must be incorporated in the theoretical analysis to ensure that the proposed solutions would help not only the current transfer system but also the whole scheme of inter-governmental specific grants that is fit to Indonesian long-term design of fiscal decentralization policy. Yet the solutions must be feasible given the fact that democratization and the political system development are still on progress and the country has not reached a full-fledged democracy. There are three elements that should be considered in the white paper on DAK, i.e. conceptual improvement of allocation system, the utilization of the fund at the sub-national governments, and the reporting system on their performance.

The Concept of Improving DAK Allocation

With regards to the issue of multi-objectives, the concept of DAK allocation can actually be improved by focusing more on two objectives, namely: 1) to finance special activities according to national priorities, and 2) to reduce fiscal inequalities among the districts. Although the proportion of DAK among the whole inter-governmental transfers is less than 10%, the DAK could help in ameliorating the fiscal inequality if it takes local governments' fiscal capacity into consideration. There is an urgent need to redesign the formula for DAK allocation. For example, it can be made less complex than the current formula while trying to change it in such a way to channel more funds to districts with a low fiscal capacity. The current formula on fiscal capacity tends to give more DAK funds to small and resource-rich districts. Therefore, it must be changed using the calculation of fiscal capacity map (provided by the MoF in the document of PMK 174/2009), which might require a revision in the Government Regulation No.55/2005 (article 55) and the adjustment of special criteria as stated in Law No.33/2004 (article 40).

DAK allocations should be returned to the original concept of specific grants. It has to follow the rule of *daerah tertentu* (selected districts) only. By gradually reduce the number of eligible districts for DAK allocations, the average

amount of sectoral DAK per district can be increased. For example, in line with the RPJMN timetable that has been set up by the Bappenas, the percentage of all districts received DAK funds in eight sectors can be reduced from over 80% in 2010, to 70% in 2011, 60% in 2012, and 50% in 2014. To ensure that this policy is consistently implemented, it is instrumental to have inter-ministerial coordination among the strategic institutions such as Bappenas, MoF, MoHA and technical ministries allocating sectoral funds.

In order to prevent bad political behaviour of the *pemekaran*, there are some possible options in using DAK allocations as the instruments. First, the Bappenas should phase out the DAK *Prasarana Pemerintah* for the newly created districts. By removing this type of DAK from the *Rencana Kerja Pemerintah* (Annual Work Plan), the Bappenas could send a clear message to local leaders that *pemekaran* is not considered as a national priority. The medium term plan of RPJMN should also fix parameters of DAK allocation formula so that the parameters are not easily subject to political intervention. Second, the method of calculating DAK allocations for districts that underwent boundary change must be removed. The MoF could remove this method so that DAK effects on *pemekaran* can be substantially reduced. Third, the tendency that DAK is mainly used for infrastructure, that is mostly unproductive and irrelevant to service delivery improvement, should be eliminated. Even if the MoHA would like to help financing local government complex buildings in the newly created governments, the responsibility can be retained by the central government under the scheme of *Tugas Pembantuan*.

The *Dana Penyesuaian* is a scheme that supposed to relate to the DAK, but apparently it has problems in terms of transparency, inequality and predictability. However, the current political context would not accept a total omission of the *Dana Penyesuaian* from the inter-governmental transfer pattern. Therefore, a realistic approach in improving local government funding performance is to ensure that the *Dana Penyesuaian* would not exceed the total DAK allocation. This would put a limit on the political intervention in DAK allocation and would require a substantial revision to Law No.33/2004.

Unsynchronized budget cycles between the national government and sub-national governments has to be addressed because this is exactly one of the crucial factors determining the predictability of DAK allocation. PP No.55/2005 stipulates that district governments are supposed to submit a draft budget to the DPRD by October and the DPRD approve the budget by November. However, the MoF requires the district governments to issue the DAK allocation also by November so that it would be too late to include this in the draft budget. As the district governments invariably use last year's DAK amount for predicting DAK component in the local budgets, most of the district authorities would have to revise the DAK budgets in the second half of the fiscal year.

There are two policy alternatives to address the issue on DAK predictability. First, the MoF should issue indicative DAK allocations earlier than the current applied schedule (presumably September or earlier, instead of November). This would give enough time for the district government authorities to prepare comprehensive plans and to incorporate DAK allocations in their

budgets. Second, a more drastic approach is to change the budget cycles on the part of provincial and kabupaten/kota governments. At present, the national and sub-national budgeting cycles are scheduled according to calendar, all starts at 1 January and ends at 31 December. While retaining this budget cycle for national government, it would be a good idea to change the budget cycles for provincial and district governments into the system that was applied during the New Order administration, i.e. it starts at 1 April and ends at 31 March the following year. This alternative would be practically feasible given the fact that in the first months of the calendar there is no significant activity at the provincial and the district level.

Most of the district governments do not use DAK funds appropriately as the system is not provided by viable monitoring and evaluation. The Bappenas, MoF and MoHA are urgently required to set up a monitoring and evaluation in order to gauge to what extent DAK has achieved its objectives. The present reporting system does not really monitor and evaluate the DAK allocation. It only monitors the number of outputs (such as number of school buildings rehabilitated or number of roads renovated). The impacts of these outputs on achieving national priorities (such as increasing school enrollment rates, increasing transport efficiency, etc) are not considered appropriately. The Bappenas, together with the MoF and MoHA has recently issued Joint Circular Letter or *Surat Edaran Bersama* (SEB) of the State Ministry of National Development Planning Agency/Head of Bappenas, Ministry of Finance, and Ministry of Home Affairs Number 0239/M.PPN/11/2008; SE 1722/MK.07/2008; 900/3556/SJ on Guidelines for Monitoring Technical Implementation and Evaluating the Utilization of DAK). However, it appears that there has been no significant progress to implement this inter-ministerial agreement to improve the DAK-financed projects at the sub-national government level.

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